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ZNR UUUUU ZZH
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FM AMEMBASSY MEXICO
TO RUCPDOC/DEPT OF COMMERCE WASHDC PRIORITY
INFO RUEHC/SECSTATE WASHDC PRIORITY 5056

UNCLAS MEXICO 000346

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FOR SECRETARY GUTIERREZ FROM AMBASSADOR GARZA
STATE FOR WHA/EX

E.O. 12958: N/A

TAGS: BEXP ETRD ECON KJUS PREL MX

SUBJECT: SCENESETTER FOR COMMERCE SECRETARY GUTIERREZ'S
JANUARY 31-FEBRUARY 1 VISIT TO MEXICO

¶1. (SBU) Summary: We welcome your visit to Mexico City as an unparalleled opportunity to set the stage and coordinate with the new Mexican government on concrete measures we can take together to move the relationship forward in many important economic areas, including improving competitiveness in North America and facilitating the flow of goods across our common border. End Summary.

The Mexican Political Landscape

¶2. (SBU) In his first weeks in office, President Felipe Calderon Hinojosa seized the initiative on several important issues, demonstrating his intent to forge an activist presidency. The change in atmospherics between the Fox and Calderon administrations has been evident from Calderon's first day in office: his insistence on taking the oath in the Chamber of Deputies, notwithstanding opposition efforts to block the ceremony, portrayed to the nation a leader who would not bow to pressure. Historically large counter narcotics operations, followed by a decisive move against narcotics kingpins this past week, as well as actions against key participants in a nettlesome political conflict in the state of Oaxaca, all demonstrate his understanding that Mexicans are looking for executive action. Some observers believe his most important accomplishment to date has been restoring to the presidency the aura of authority that many believe was eroded by President Fox's informal and disengaged manner.

¶3. (SBU) Nevertheless, the political climate remains conflictive. It remains to be seen just how much political and financial support losing presidential contender and self-proclaimed "alternative president," Lopez Obrador retains. His support and media attention have dwindled in recent weeks even as he seeks to further a divisive and disruptive political agenda. His party, the left of center Democratic Revolutionary Party (PRD), remains divided and unable to fashion a national political agenda. A large segment of Mexico's public feels it gained little from economic and political reforms of recent years. President Calderon faces the challenge of reaching out to the constituency captured by Lopez Obrador during the election, addressing the depth of poverty and social disparities in Mexico, while moving ahead with the sometimes painful structural reforms that are essential if Mexico is to remain competitive in a global framework.

¶4. (SBU) At the same time, Calderon must advance his law enforcement agenda in the face of spiraling narcotics-related violence. Through decisive actions in recent weeks (deployment of security forces to narco-trafficking hot zones

of Michoacan, Guerrero, Tijuana and northern border states, and the unprecedented extradition of several major narcotics traffickers wanted in the U.S. on January 19), Calderon has shown he is committed to tackling this issue. That said, the influence of the illegal trade in drugs is as corrosive in Mexico as it is pervasive. The battle may have been joined, but it will be a protracted one.

¶5. (SBU) The difficulties and challenges are compounded by the legislative landscape. The results of the 2006 congressional races reflected completion of an historic realignment in Mexican politics, with the long hegemonic Institutional Revolutionary Party (PRI) relegated to third place in what is now a highly competitive multiparty system. As no party enjoys a legislative majority, the PAN will need support from minor parties and at least some PRI members in order to govern. The PRI's experienced legislative leadership is prepared to cooperate with the PAN on a range of specific issues, without offering across-the board cooperation. The PRI will be wary of supporting controversial reform initiatives that carry a high political cost. As the 2009 midterm elections approach, we expect the PRI to distance itself from the PAN further, to reassert a distinct political identity.

Economics and Mexico's Competitiveness

¶6. (U) President Calderon inherited a stable, growing economy tightly linked to U.S. economic cycles. Mexico chalked up an estimated 4.7% growth rate in 2006, rebounding from near zero growth in the first years of the decade. Real GDP growth is expected to slow to around 3.5% this year. Public finances have improved steadily in recent years, boosted by sound macroeconomic management and high oil prices. Inflation has risen in recent months to around 4%, but is under control.

International investors seeking higher yields have embraced Mexican bonds. Debt and equity markets are stable. Mexico's exports to the U.S. (which account for almost 90% of all Mexico's exports) continue to grow at double-digit rates. Many here are growing concerned, however, about Mexico's future in an increasingly globalized world. Rising Asian economic powers like China (which nipped Mexico to become the second-largest U.S. trading partner last year) are taking market share from Mexican producers both at home and in the all-important U.S. market, while foreign investment and manufacturing capacity is increasingly heading across the Pacific. To assure Mexico's ability to compete in this new environment, Calderon will need to tackle a series of essential structural reforms.

¶7. (SBU) Constitutional restrictions on foreign involvement have hindered Mexico's ability to replace declining oil reserves. Its dependence on oil-related revenues for 37% of its federal budget could easily lead to serious budget woes, possibly in 2007 but more likely in 2008 and 2009. In the Western Hemisphere, only Guatemala and Haiti have a lower tax collection rate than Mexico. Poor tax collection has slowed critical investments in education, health, and transportation infrastructure and will limit Calderon's ability to respond responsibly to demands from his political opposition.

¶8. (U) After crude oil revenues, remittances have become Mexico's second largest source of foreign exchange, ahead of foreign direct investment and tourism receipts. Through November 2006, remittances totaled \$21.3 billion, up 16.5% from the same period in 2005. This sum is triple the \$6.6 billion received in all of 2000. Remittance revenues support many of the poorest families in Mexico. For them, remittance income is critical, if not for survival, at least for maintenance of their modest standard of living.

¶9. (U) Other economic challenges facing Calderon include reform of Mexico's public pensions system, which has large unfunded liabilities that each year consume a greater portion of the budget. Labor market rigidity and lack of competition in a number of sectors (telephones, broadcasting,

construction, cement, etc.) are also significant obstacles to boosting economic growth. Few major reform proposals will move forward without some confrontation with unions representing workers in the affected industries, including teachers, telecommunications, transportation, and mining workers. The scheduled full opening of agricultural trade under NAFTA in 2008 is a major challenge. Two of the most politically sensitive products in Mexico are corn and dried beans. Mexico has over two million corn farmers, most of whom cultivate less than two hectares. Some agricultural organizations and the PRD have argued that a full opening of agricultural trade in 2008 would cause severe social upheavals, as large numbers of farmers are forced out of business and further impoverished.

¶10. (SBU) A key test for Calderon is whether he will be able to build the political consensus to tackle the structural changes Mexico needs to be more competitive in the global economy. He chose a well-regarded team for his economic cabinet, including the highly-respected former IMF Deputy Managing Director Agustin Carstens as Finance Secretary and Eduardo Sojo -- an experienced economic advisor and political operative in the Fox administration -- as Secretary of the Economy. Nevertheless, the sensitive political situation outlined above may lead Calderon to refrain from spending too much political capital on controversial economic reform issues early on. He understands the early imperative of winning over skeptics, particularly among those Lopez Obrador supporters who perceive Calderon's party as representing the interests of the elite. Accordingly, many of his early initiatives will be focused on addressing Mexico's core social problems of poverty and inequality, while seeking to improve Mexico's competitiveness through improvements in education and infrastructure.

The Border - Facilitating Legal Trade

¶11. (SBU) The U.S.-Mexico border presents an enormous set of critical challenges for both countries. The immigration reform debate in the U.S., the flow of illegal migrants, insecurity and lawlessness in the Mexican border regions, trafficking in narcotics and other types of smuggling are key factors. We are rightly focused on the many criminal activities prevalent at the border and the need to reduce their influence in the U.S. On the positive side, in addition to anti-terrorism cooperation, the last few years

have seen much improved U.S.-Mexican cooperation in counter-narcotics operations and extraditions.

¶12. (U) At the same time, annual two-way legitimate commercial trade between the U.S. and Mexico through November 2006 was \$465 billion. Numerous studies and trade groups, including the 2006 recommendations of the North American Competitiveness Council, have stressed that border facilities and procedures should be improved significantly to accommodate current trade flows and expected future growth. Commerce A/S Bohigian heard this message loud and clear in his two recent visits to the border region. In this context, it would be useful for both nations to make at least short-term fixes at a number of key border points with the aim of moving legitimate commerce more efficiently in both directions. In some cases, this simply means extending and/or synchronizing operating hours at U.S. and Mexican facilities at the same border crossing, and sharing best practices among ports of entry. There are also serious infrastructure problems at our border crossing points. Both nations will need to address the need to physically expand ports of entry and related infrastructure, and to add additional personnel.

¶13. (U) California and Baja California have begun a series of studies/talks aimed at a "trade master plan" in light of the difficulty of achieving more effective trade facilitation at the federal level. Governor Schwarzenegger spoke about this state-level effort when he was in Mexico City and met with Calderon in November 2006.

¶14. (SBU) The key to actual bilateral progress on trade facilitation in 2007 will be engagement by senior U.S. and Mexican officials, including DHS and the Mexican SCT (transport ministry). The fact is that we can deliver needed short-term fixes and longer-term strategies with top-level involvement in both countries. Moving legal trade better across the border is part of the positive tone and engagement that we need under the Prosperity pillar of the Security and Prosperity Partnership (SPP). Importantly, it meets a very real commercial need.

Rule of Law

¶15. (SBU) Rule of law problems stemming from an inefficient and easily abused judicial system have plagued U.S. and Mexican companies, and negatively affect the investment climate. We are deeply concerned about a trend to criminalize cases that are typically considered commercial disputes. Criminalizing these disputes is an abuse of the judicial system by some Mexican companies to consolidate their protected position in Mexico and exclude strong competitors. U.S. companies such as Tyco and General Electric/NBC have become victims of this disturbing trend, costing them substantial time, resources and money dedicated to their defense. Such cases send a negative signal to other potential investors, undermining their confidence in the Mexican legal system and willingness to invest in this market.

¶16. (SBU) Thanks in part to technical assistance from USAID, there has been some reform. Three Mexican states have passed legislation permitting oral trials in criminal cases; two have actually implemented the reforms. Seven additional states are developing judicial reform proposals while another 16 are studying the matter. Legislation pending before the federal congress would, if passed, provide an opportunity to substantially improve the effectiveness, efficiency and transparency of Mexico's antiquated and corrupt judiciary. President Calderon has expressed support for oral trials and judicial reform, as have the three main party whips in Congress and the newly-elected Supreme Court President. We face the very real possibility of being able to help Mexico achieve a reform that would facilitate law enforcement cooperation, provide a better chance for viable prosecutions, strengthen enforcement of intellectual property rights, and ensure better protections for American residents, visitors and investors in Mexico from nuisance suits and criminalization of commercial disputes. We should do all we can to encourage the Mexican Government to move forward, and reevaluate our own ability to support a radical improvement in Mexico's judiciary in the face of pending cuts in USG assistance to Mexico.

Immigration

¶17. (SBU) Mexicans across the political spectrum have expressed indignation about the border fence, even while evincing a lack of understanding of its details and likely affect. Authorization of the fence represents a response to Mexico's inability to enforce rule of law on its side of the border, and its failure to create adequate economic opportunities for its people. If the issue is raised during your meetings, you can reiterate that the United States is a nation of laws, that Americans abhor the flagrant disregard for the law, and that the fence is a necessary tool to ensure our border security and the enforcement of our immigration laws. In order not to focus on our differences, you can stress President Bush's personal commitment to comprehensive immigration reform and support for President Calderon's efforts to increase jobs and economic development. While Mexican expectations continue to include U.S. immigration reform, the Calderon administration will seek to achieve what Fox did not in a low-key effort that avoids making migration the dominant bilateral issue. Our challenge is to encourage realistic expectations, explaining those U.S. domestic

political factors affecting the issue of migration.

Cuba and Venezuela

¶18. (SBU) During the January 9-10 annual meeting of Mexican ambassadors and counsels, Foreign Secretary Espinosa confirmed the administration's wish to significantly improve Mexico's relations with Cuba and Venezuela, noting that Mexico has historically had friendly relations with these states and wants to amend any differences with them. Underscoring this message, President Calderon told his country's top diplomats to execute a "responsible active foreign policy," calling on Mexico to assume leadership in international and regional forums -- particularly in Latin America -- and conduct respectful relations with all countries. It seems doubtful that the Mexican government expects either Venezuela or Cuba to respond positively to its offer of improved relations, but Calderon is showing that he is taking Mexico's foreign policy in a new direction from that of the Fox administration and does not want to alienate anyone in the region at this early stage.

Closing

¶19. (U) In closing, I would like to thank you for coming to Mexico. We are eager to work with President Calderon and his team; who share a similar world view, have a viable vision for Mexico's future, and most importantly are keen to work with us in shaping that future. They represent natural allies in tackling the challenges confronting our two nations and our region. We will seek to emphasize concrete results we can both applaud in the security (including military-to-military), counter-narcotics, border facilitation, economic reform, trade and education agendas. Your presence sends a clear message as to the importance we attach to continued good relations with our southern neighbor, facilitating early progress on our bilateral agenda. If there is anything I or my staff can do to make your visit more enjoyable or productive, please do not hesitate to let me know.

Sincerely, Antonio O. Garza, Jr.

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